



Investment Consultant's Report



The CalSTRS investment portfolio declined by \$6.1 billion over the past year ending with a value of \$96.7 billion on June 30, 2002. As highlighted below, the CalSTRS portfolio is broadly diversified, holding investments ranging from publicly-traded short-term bonds to privately-held partnerships. Clearly, the scale and breadth of investments make the management and oversight of these assets highly complex. In light of these factors, CalSTRS has been effective in using its resources in a cost-efficient manner to ensure that benefits continue to flow to CalSTRS participants.

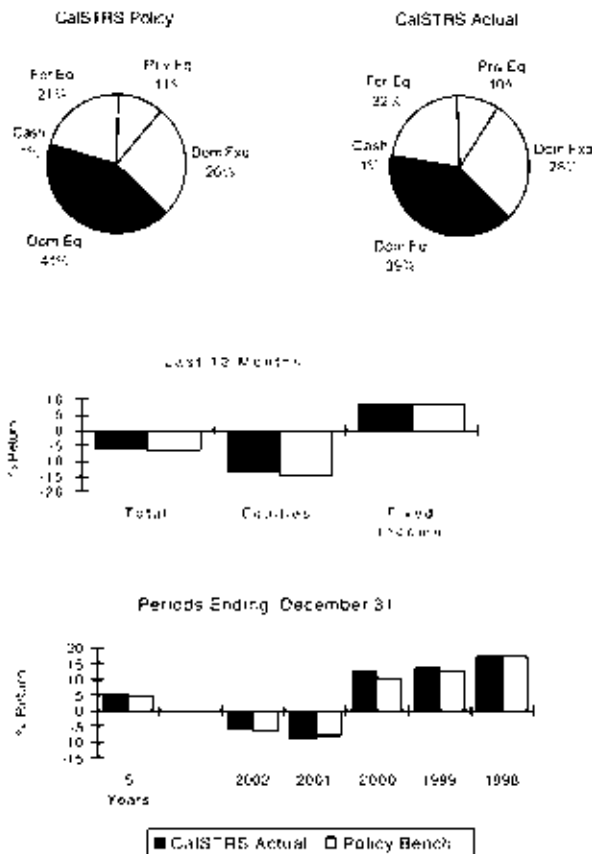
Investment Allocation

The most critical factor influencing overall investment performance is the allocation of the CalSTRS portfolio across major asset classes. The current policy reflects an asset allocation structure adopted for the 2002-2003 fiscal year (see left pie chart) as a step towards long-term targets adopted in October of 2001. The portfolio's actual allocation is slightly different from policy. Foreign equity and Domestic Debt are slightly overweighted while Domestic Equity and Private Equity are slightly underweighted (see right pie chart).

Investment Results

Over the last year, the CalSTRS investment portfolio produced an overall return of minus (5.9%) ranking near median among its large public pension fund peers¹ (top bar chart). The portfolio outperformed policy by approximately 70 basis points largely due to relative outperformance of the Fund's Domestic and Foreign equity asset classes.²

During the last three years, CalSTRS' portfolio generated a minus (1.2%) return (third quartile vs. peer funds) versus minus (1.7%) for the policy benchmark. Over the last five years, the CalSTRS investment portfolio produced an average annual return of 5.0%, exceeding its policy benchmark by 30 basis points per year (bottom chart). Successive one-year periods are shown as well. For periods ending June 30, CalSTRS' portfolio has outperformed its policy benchmark in three of the latest five one-year periods.³



¹ Per TUCS Universe for Public Funds with assets in excess of \$1 billion

² The policy benchmark consists of passively managed asset class portfolios weighted by CalSTRS' policy allocations. The difference between actual results and the benchmark are due to two factors: i) deviations from policy and ii) active decisions on the part of CalSTRS and its investment managers

³ CalSTRS investment performance is calculated using a monthly internal rate of return and day-weighted cash flows. Periods longer than one month are geometrically linked. This method of return calculation complies with AIMR performance presentation standards

The prolonged negative (bear) market in U.S. and Non-U.S. stocks contributed to a second year of decline in the market value of the CalSTRS' investment portfolio from \$102.8 to \$96.7 billion. The best portfolio strategy during difficult times is portfolio diversification. The declines in the U.S. and Non-U.S. equity portfolio were lessened by the strong positive returns in the Fixed Income and Real Estate portfolio. The CalSTRS' investment portfolio is invested in a broad number of asset classes and strategies to capture opportunities throughout the economic cycle. CalSTRS continues to be very well funded to meet all the benefit obligations to present-day retirees and future retirees.

During this difficult market, diversification has continued to benefit the Teachers' Retirement Fund. This is evident when comparing CalSTRS' current experience with that of the corporate pension funds during the last deep bear market of 1974–1975, when many of those funds declined over 25 percent. During this two-year bear market, the CalSTRS' portfolio has declined roughly 15 percent from its peak, all while capturing most of the great positive returns from the late 1990's. As students of financial history, the Investment Committee and investment staff anticipate that markets will cycle and have developed a strategy to ensure the long-term strength of the CalSTRS' portfolio. At the end of the fiscal year the CalSTRS' portfolio allocation was as follows: U.S. Equity 39.2 percent, Non-U.S. Equity 21.9 percent, Alternative Investments 4.4 percent, Fixed Income 28.0 percent,

Real Estate 5.2 percent and short-term investments (cash) 1.3 percent.

As a perpetual defined benefit plan, CalSTRS has a very long investment time horizon. It is always difficult to ride through tough times. Yet, history has proven time and again, that a consistent investment philosophy and policy can help keep one's perspective looking out toward the goal, all the while those around you are tossed about by the daily news and events.

Many people are concerned that the stock market has taken back some of the gains from the late 1990's. Participants in the CalSTRS Defined Benefit Program must always keep in mind that the benefits are defined and are not affected by the changes in the portfolio's value. A broad perspective and a glimpse back over the past 10 years prove out the statement that the Defined Benefit Program is still in a very strong financial condition. As you review the accompanying charts look back over the past ten years and note that, despite the recent decline, the Teachers' Retirement Fund remains much larger and healthier than a decade ago.

Chart A illustrates the growth in the total investment portfolio, excluding securities lending collateral, over the

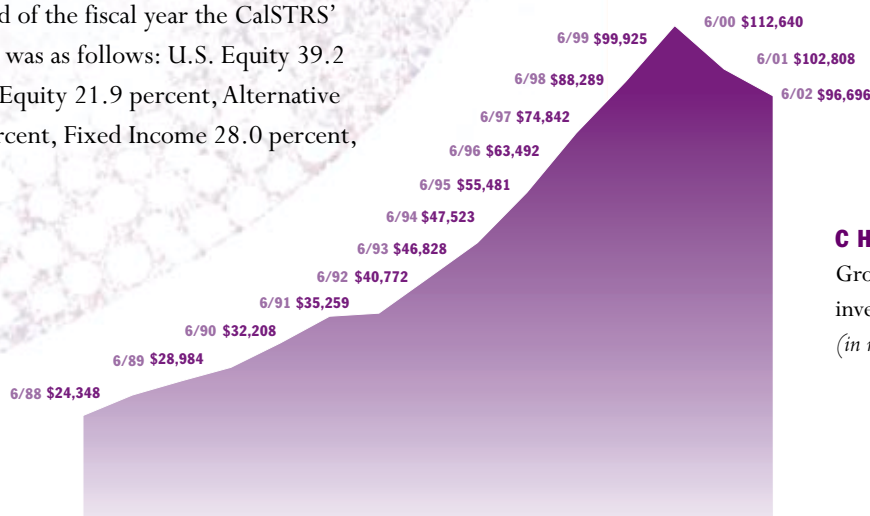


CHART A
Growth in total
investments
(in millions)



ASSET ALLOCATION (6/30/02)

Total investment portfolio of \$96.7 billion

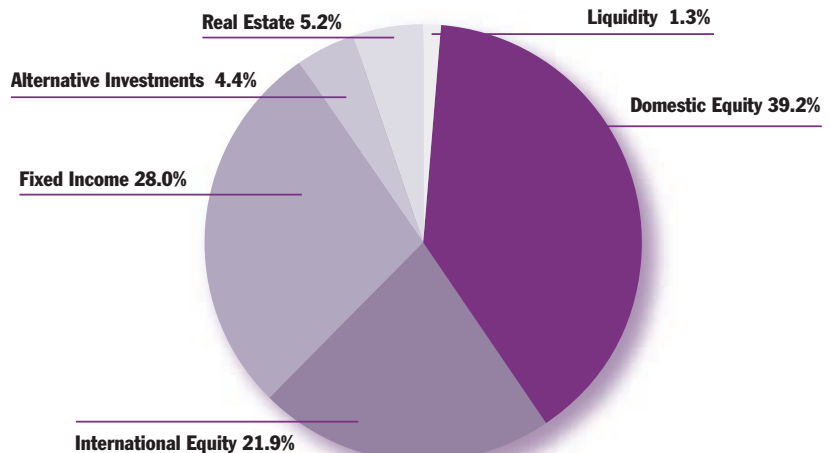
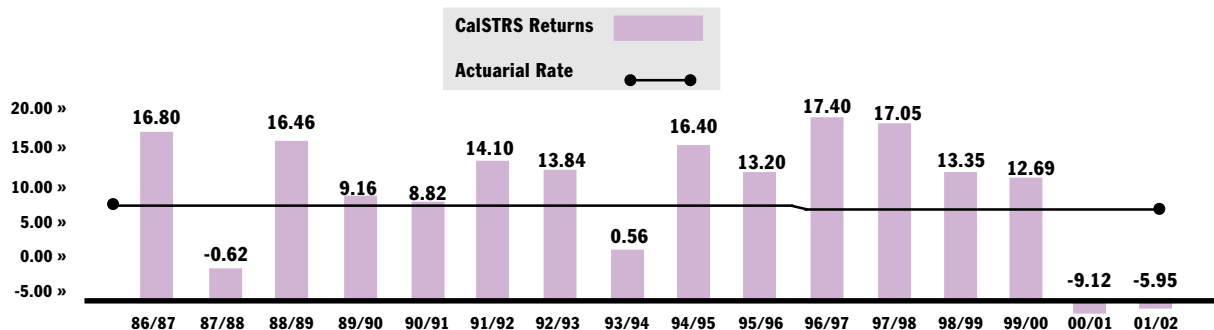


CHART B

Growth in CalSTRS' returns (percent)



past 15 years. Chart B compares CalSTRS' returns with the three-year average assumed actuarial goal for the Fund. Chart C shows the performance returns for all of the asset classes in the portfolio relative to their benchmark indices. The return calculations are consistent with Association of Investment Management and Research performance presentation standards.

BENCHMARK CHANGES

During the past fiscal year the CalSTRS Investment Committee reviewed and approved new benchmarks for both the U.S. Equity and Fixed Income asset classes. The Russell 3000 Index was selected for U.S. Equity and the Lehman Brothers U.S. Aggregate and HighYield Cash Pay

for Fixed Income. As a result of the new index benchmark changes, adjustments have been undertaken within both asset classes. In addition, the Investment Committee continued to have all of the investment benchmarks modified to exclude tobacco companies.

OBJECTIVES

The core objectives of the Investment Management Plan remained unchanged. The primary objectives are set forth in the California Constitution and the California Education Code. The foremost objective is to provide for present and future benefit payments, then to diversify the assets, and finally, endeavor to reduce CalSTRS funding costs.

CHART C

Performance returns for major asset categories

Portfolio Type / Associated Indices	1 Yr	3 Yr	5 Yr	10 Yr
Total Fund	-5.95	-1.24	5.03	8.51
<i>Domestic Equity</i>	-16.68	-7.71	3.68	10.88
Russell 3000 *	-17.34	-8.14	3.70	11.19
Wilshire 5000	-16.62	-8.21	3.57	11.05
<i>International Equity</i>	-8.09	-5.61	-0.88	N/A
MSCI All Country Free ex US (G) *	-8.37	-6.39	-1.85	5.42
MSCI Europe, Australia & Far East *	-9.73	-6.87	-1.60	5.37
MSCI Emerging Market Free *	1.31	-6.47	-8.49	2.47
<i>Fixed Income</i>	8.47	7.97	8.02	8.13
Salomon LPF	8.78	8.23	7.88	8.05
<i>Real Estate</i>	11.11	11.34	14.89	7.96
Real Estate Custom **	6.34	9.47	11.42	8.08
<i>Alternative Investments</i>	-8.02	11.97	17.44	18.91
Alternative Investments Custom ***	4.09	7.02	9.46	N/A
<i>Liquidity</i>	3.86	5.70	5.84	5.52
Salomon 3-Month Treasury Bill	2.46	4.46	4.66	4.58

* CalSTRS adopted tobacco free indices beginning 9/1/00

** NCRIEF after 7/1/97 and Institutional Property Consultants prior to 7/1/97; lagged 1 quarter

*** Blend of the [Russell 3000 + 5% + 90 day T-Bill] after 4/1/99 and [CPI + 12%] prior to 4/1/99; lagged 1 quarter

Additionally, the Teachers' Retirement Board and staff strive to run the investment program in such a manner so as to maintain the trust of the participants and public.

FIXED INCOME

The fixed income assets within the CalSTRS Investment Portfolio include internally managed investment grade securities of approximately \$26.3 billion and externally managed high yield securities of approximately \$783 million, which collectively are expected to generate a risk-adjusted return that is representative of the broad market-weighted universe of U.S. bonds. The strategic performance objective for the Fund's fixed income portfolios is to consistently exceed the total return of the

broad market-weighted benchmark by following an enhanced indexing strategy for the internally managed portion and an active strategy for the externally managed high yield portion. Incremental value is to be added by allocating assets among the different market sectors and by taking advantage of specific investment opportunities within each of those market sectors. For the fiscal year ended June 30, 2002, the fixed income portfolios trailed the performance benchmark return of 8.78 percent by 31 basis points.

In June 2002, the Teachers' Retirement Board adopted a new performance benchmark for the Fund's fixed income assets. This was noteworthy in that the previous fixed income performance benchmark was in place for fifteen



years and operated within a customized, fixed sector-weighted framework. The new benchmark selected is designed to be representative of the sectors within the U.S. bond market, and is therefore classified as a broad market-weighted index. The primary implication of the change in benchmarks is a significant expansion of the opportunity available for investment that more accurately reflects the fixed income markets.

The Fixed Income unit also manages three other programs: Currency Hedging, Home Loan and Securities Lending.

Currency Hedging Program

The Currency Hedging Program was developed in conjunction with the Fund's 20 percent strategic allocation to non-dollar equities, all of which have an unhedged performance benchmark. As a result, the ability to hedge (or sell) the underlying foreign currency exposure is intended to preserve the value of the non-dollar equity assets during periods of a strengthening dollar. Through the fiscal year ended June 30, 2002, the Currency Hedging Program generated approximately \$620 million in additional income.

Home Loan Program

The CalSTRS Home Loan Program was established as a result of legislation designed to provide value to the membership in the form of a mortgage loan at a market rate, while meeting the investment goals of the System by generating a mortgage asset. The assets created by the program are either purchased and managed as part of the mortgage allocation within the fixed income portfolio, or sold in the financial markets. Currently, three loan programs are offered through participating Correspondent Lenders who generate approximately \$40 million in mortgage loans every month. Over the past several years, Home Loan Program staff has concentrated on program revitalization and developing loan programs that address unmet needs within the membership, such as affordability, recruitment and retention issues. Looking forward, this focus on affordability and recruitment programs is expected to continue. In addition, staff will pursue opportunities and strategies to develop additional alliances with agencies and organizations that complement the CalSTRS Home Loan Program.

CHART D

Largest fixed income holdings as of June 30, 2002 (*CalSTRS maintains a complete list of portfolio holdings*)

Issue	Maturity Date	Interest Rate	Par	Market Value	Average Cost	Unrealized Gain/(Loss)
USTREAS BDS	15-Feb-20	8.500%	300,000,000	397,703,970	359,911,925	37,792,045
USTREAS BDS	15-Feb-15	11.250%	235,000,000	365,363,900	330,357,194	35,006,706
USTREAS BDS	15-May-17	8.750%	250,000,000	333,607,475	257,774,050	75,833,425
USTREAS BDS	15-Aug-22	7.250%	270,000,000	321,642,900	306,693,179	14,949,721
USTREAS BDS	15-Feb-19	8.875%	220,000,000	299,237,400	242,123,371	57,114,029
FEDERAL NATL MTG ASSN	17-Feb-11	6.250%	250,000,000	256,892,200	250,000,000	6,892,200
USTREAS BDS	15-Aug-19	8.125%	200,000,000	256,208,000	207,642,162	48,565,838
USTREAS BDS	15-Nov-21	8.000%	200,000,000	255,854,000	246,394,331	9,459,669
USTREAS BDS	15-Nov-16	7.500%	200,000,000	240,782,000	206,136,195	34,645,805
USTREAS BDS	15-Aug-17	8.875%	175,000,000	236,120,500	193,937,988	42,182,512

CHART E

Largest equity holdings as of June 30, 2002 (*CalSTRS maintains a complete list of portfolio holdings*)

Issue	Shares	Market Value	Average Cost	Unrealized Gain/(Loss)
General Electric Co.	34,572,783	1,004,339,346	578,323,208	426,016,138
Exxon Mobil Corp.	22,546,104	922,586,576	492,092,983	430,493,593
Microsoft Corp.	15,729,408	860,398,618	475,502,127	384,896,490
Pfizer Inc.	22,383,932	783,437,620	419,858,370	363,579,250
Citigroup Inc.	17,992,251	697,199,726	394,180,702	303,019,024
American Intl Group Inc.	8,148,680	555,984,436	240,354,143	315,630,293
Wal Mart Stores Inc.	10,097,680	555,473,377	196,898,996	358,574,381
Johnson & Johnson.	10,399,731	543,489,942	295,798,501	247,691,441
BP plc.	52,681,733	442,468,129	322,383,339	120,084,789
Intel Corp.	23,132,672	422,633,917	297,581,294	125,052,624

Securities Lending Program

The Securities Lending Program is designed to enable the Fund to use its existing asset base of lendable securities and investment expertise to generate incremental income. The strategic performance objective for the program is to earn income commensurate with the market demand for the securities made available for lending and the return earned on the investment of cash collateral, all within the guidelines set forth by CalSTRS intended to mitigate the risks associated with securities lending. For the fiscal year ending June 30, 2002, the Securities Lending Program earned approximately \$90 million, making it the program's best performing year since its inception in 1988. There were a number of factors that contributed to the performance. The program had just recently been restructured, and the investment markets were as bond-friendly as ever, with the Federal Reserve lowering short-term interest rates an unprecedented 475 basis points.

INTERNAL EQUITY MANAGEMENT

The objective for Internal Equity Management is to implement a portion of the passive component of the

domestic equity allocation. The performance objective of the internally managed portfolio was to closely track the return of the S&P 500 ex-Tobacco Index. As of June 30, 2002, the portfolio had a market value of \$13.4 billion. The return of the portfolio was -18.21 and -9.41 percent for the one-year and three-year periods, respectively. The portfolio met its objective to closely track the index. During the fiscal year, the CalSTRS Investment Committee reviewed and approved the Russell 1000 Index (ex-Tobacco) as the benchmark for the portfolio. The change to the new benchmark occurred on July 1, 2002.

The Cash Equitization Program enables CalSTRS' domestic equity allocation to remain close to the Board-approved strategic asset allocation policy target. The program seeks to achieve the total return of the S&P 500 Index by holding S&P 500 futures contracts or other similar securities, backed by a portfolio of short-term fixed income securities. As of June 30, 2002, the program had a market value of \$115 million. The return of the program was -16.33 and -8.51 percent for the one-year and three-year periods, respectively. The program outperformed its benchmark in each period by 1.66 and 0.67 percent, respectively.



INVESTMENTS

CHART F

Investment summary for the year ended June 30, 2002 (*in millions*)

Portfolio Type	30-Jun-01		30-Jun-02			
	Book Value	Market Value	Book Value	Market Value	% of Market Value	Net Market Change
Domestic Equity	23,587	39,951	28,628	37,887	39.18%	-2,064
International Equity	22,829	22,984	21,972	21,220	21.95%	-1,764
Fixed Income	27,498	28,217	26,260	27,065	27.99%	-1,152
Alternative Investments	3,987	4,515	4,136	4,257	4.40%	-258
Real Estate	5,257	5,274	5,210	5,034	5.21%	-240
Liquidity	1,867	1,867	1,233	1,233	1.28%	-634
Total Portfolio	85,026	102,808	87,439	96,696	100.00%	-6,112
Plus: Securities Lending Collateral		17,728		13,325		
Less: Accruals		381		181		
Less: Cash & Cash Equiv		—		65		
Plan Net Assets-Investments		120,155		109,775		

CHART G

Schedule of fees July 1, 2001 through June 30, 2002 (*in thousands*)

	Assets Under Management	Fees	Basis Points
Investment Managers' Fees:			
Domestic Equity	\$23,252,255	\$22,367	9.6
International Equity	21,219,715	33,618	15.8
Fixed Income	782,874	285	3.6
Alternative Investments	4,257,368	1,455	3.4
Real Estate	5,034,253	16,969	33.7
Total Investment Managers' Fees	\$54,546,465	\$74,693	13.7

CHART H

Broker commissions (July 1, 2001 through June 30, 2002)

Broker Name	Commission	Shares	Commission per Share
<i>Domestic Equity Transactions</i>			
Investment Technology Group Inc	939,887	50,550,926	0.019
Salomon Smith Barney Inc	698,270	19,442,929	0.036
Jackson Securities	576,244	10,297,798	0.056
Lehman Brothers Inc	442,625	10,018,684	0.044
Capital Institutional Services	433,399	8,336,212	0.052
Goldman Sachs	407,194	14,109,872	0.029
Instinet Corporation	395,023	17,094,150	0.023
Merrill Lynch Professional Clearing Corp	391,570	9,056,430	0.043
ABN AMRO Inc	384,818	7,296,550	0.053
Credit Suisse First Boston Corporation	332,231	9,607,301	0.035
Other Domestic Brokers	7,015,875	240,808,212	0.029
Total Domestic Commissions	12,017,136	396,619,064	0.030
<i>International Equity Transactions</i>			
Merrill Lynch	3,321,533	2,447,416,614	0.001
UBS Warburg	1,966,688	258,760,800	0.008
Morgan Stanley	1,759,127	102,735,248	0.017
Salomon Bros	1,581,522	180,554,410	0.009
Goldman Sachs	1,386,484	147,663,822	0.009
Credit Suisse First Boston	1,255,206	219,496,330	0.006
Lehman Brothers Inc	1,022,595	81,405,651	0.013
J.P. Morgan Securities Ltd	920,466	343,419,786	0.003
Deutsche Banc	850,229	185,357,913	0.005
HSBC Securities	745,955	59,114,567	0.013
Other International Brokers	6,862,346	1,652,231,047	0.004
Total International Commissions	21,672,150	5,678,156,188	0.004



ALTERNATIVE INVESTMENTS

The Alternative Investments asset class invests in the private equity universe. These investments involve companies that are not publicly traded and normally require active involvement by the external equity managers hired by CalSTRS. The vast majority of these investments are made through limited partnership portfolios, which consist of pools of investments.

This fiscal year, CalSTRS made additional commitments of approximately \$395 million in this segment of the portfolio. Total commitments now amount to approximately \$9.0 billion. There are 113 partnerships and 12 co-investments in the Alternative Investment portfolio. At the end of the fiscal year, the total market value was \$4.3 billion, representing approximately 4.4 percent of the total CalSTRS portfolio. CalSTRS continues to increase its commitments in this area as a result of the allocation review completed at the end of June 1999. The Alternative Investment asset class has achieved annualized returns of -8.02, 11.97, and 17.44 percent, for the 1-, 3-, and 5-year periods respectively.

Credit Enhancement

CalSTRS has a credit rating of AAA/Aaa/AAA by Standard and Poor's, Moody's Investors Service, and Fitch Inc. This rating is utilized by issuers of municipal debt in California to assist in the issuance of variable rate municipal bonds. CalSTRS enters into agreements with a number of issuers of tax-exempt debt to provide the payment of principal and interest in the event of a non-payment and/or marketing support in the capital markets. In return, CalSTRS earns fee income for these commitments. Most the transactions are supported by banks or bond insurers for repayment. As of June 30, 2002, the Credit Enhancement Program had commitments of approximately \$1.3 billion and fee income earned during the fiscal year was more than \$3.2 million.

REAL ESTATE

CalSTRS portfolio of real estate assets is valued at \$5.0 billion. The real estate portfolio is comprised of 99 directly owned assets and investments in nine opportunity funds. During the last fiscal year six assets were acquired and nine assets were sold. Real estate assets are 5.2 percent of the total fund with a 6 percent allocation. The direct property portfolio is diversified as to property type and geographic location. The largest component of the direct property sector is office buildings, with the largest weighting in the western region of the United States. The CalSTRS' real estate portfolio has achieved gross annualized returns of 11.11, 11.34 and 14.89 percent, for the 1-, 3- and 5-year periods, respectively. CalSTRS' return exceeded the NCREIF benchmark by 4.77, 1.87 and 3.47 percent for each of the 1-, 3- and 5-year periods.

EXTERNAL EQUITY MANAGEMENT

During 2002, the Public Equity portfolio, which is comprised of both internally and externally managed portfolios, continued to be an important investment vehicle to the fund. In fiscal year 2001–02, this segment of the portfolio accounted for about 61.1 percent (or \$59.1 million) of the total fund. Domestic Equity accounted for 39.2 percent of the total equity allocation, while International Equity accounted for the remaining 21.9 percent.

The External Equity portfolio is managed by 16 external domestic managers and 19 external international managers. Although the equity markets were extremely volatile, CalSTRS domestic active managers added value by outperforming their benchmark by 54.6 basis points; however, CalSTRS international active managers slightly underperformed their benchmark by 30 basis points.

CORPORATE GOVERNANCE

During the 2001–02 fiscal year, CalSTRS voted on a variety of proxy issues including financial, corporate governance and social issues. More than 7,050 votes were cast on proxy issues of corporations whose shares were owned in the Investment Portfolio. These proxy issues were presented on approximately 2,700 companies. The overall number of proxy issues increased from 5,944 last year, but the number of mergers/acquisitions reviewed significantly decreased to 3 percent from just under 10 percent last year.

The major issues voted are summarized below:

1. Election of Directors: CalSTRS generally votes in favor of directors unless the proxy statement shows circumstances contrary to policy. Examples of such circumstances are: greater than 50 percent board representation by company executives, potential conflict of interest due to other directorships or employment, and classification of the company directors.

Number Voted: 2,637

For: 2,201

Against: 436

2. Selection of Auditors / Accountants: CalSTRS generally votes in favor of the independent auditors and accountants recommended by management.

Number Voted: 1,583

For: 818

Against: 765

3. Compensation Plans: (*Stock Options, Incentive Stock Options, Employee Stock Purchase Plans, etc.*) Corporations provide a variety of compensation plans to keep executives, employees and non-employee directors. A number of these plans provide for the issuance of long-term incentives to attract, reward and retain key employees. Compensation plans are evaluated based on CalSTRS Financial Responsibility Criteria.

Number Voted: 981

For: 376

Against: 605

4. Approve Merger / Acquisition–Management: CalSTRS generally votes in favor of the acquisition or merger of one company into another.

Number Voted: 177

For: 172

Against: 5

5. Corporate Actions / Corporate Governance Issues:

These are issues related to spin-offs, stock issuance, stock splits and incorporation. CalSTRS votes these proposals on a case-by-case basis.

Number Voted: 249

For: 56

Against: 193

6. Other–Miscellaneous–Management: CalSTRS generally votes in favor of other miscellaneous business recommended by management, but issues are decided on a case-by-case basis.

Number Voted: 402

For: 304

Against: 98



CASH BALANCE BENEFIT PROGRAM

The Cash Balance Benefit Program contributions have been invested into pooled funds from inception (February 1, 1997) through June 30, 2001. Sixty percent of the contributions have been allocated to the S&P 500 portfolio and 40 percent to the Government Index portfolio. Beginning July 1, 2002, Cash Balance Benefit Program contributions are invested in the Teachers' Retirement Fund excluding Private Equity (Alternative and Real Estate investments). The investment value of contributions as of June 30, 2002, is \$21.1 million. The rate of return for the Cash Balance Benefit Program for the fiscal year is -6.64 percent.

DEFINED BENEFIT SUPPLEMENT PROGRAM

The Defined Benefit Supplement Program contributions are invested in the Teachers' Retirement Fund excluding Private Equity (Alternative and Real Estate investments). Contributions were first received in the DBS Program in January 2001. The investment value of those contributions as of June 30, 2002, is \$617.8 million. Since the inception of the DBS Program, the cumulative rate of return is -7.73 percent. The rate of return for the DBS Program for the fiscal year is -6.64 percent.



